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Financial Services Policy and Financial Markets
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Dear Sir/Madam,

Eumedion welcomes the opportunity to comment on the European Commission's Green Paper on the long term financing of the European economy (hereafter: Green Paper). We support and appreciates the work that the European Commission has been undertaking to foster productivity, improve competitiveness and ensure growth within the European Union (EU). Eumedion is the dedicated representative of the interests of 69 long term institutional investors – all with a long term investor horizon – and aims to promote good corporate governance and sustainability in Dutch and European listed companies. Together they have more than € 1 trillion assets under management.

Institutional investors are rightfully identified by the European Commission and the OECD[1] as suitable long-term investors. Long term financing indeed often forms an important part of institutional investors' investment activities, as a result the match with the long duration and maturities of their liabilities. A recent Tilburg University research report, commissioned by

[1] The OECD is currently working on High-Level Principles of Long-Term Investment Financing by Institutional Investors (www.oecd.org/daf/.../HL-Principles-LTI-Public-Consultation-May-2013.pdf).

Eumedion, confirms the long-term focus of Dutch pension funds and asset managers.[2] It was found that the six largest Dutch institutional investors hold the majority of their shares in Dutch listed companies for a long period. More than 80% of the portfolio is held for 5 years or more and at least 55% of the investments are allocated to holdings of at least 10 years.

Allocation to long term finance can be done to the extent that the defined long-term investment project is in line with the institutional investors' objectives and liabilities and within the risk constrains that they can tolerate. In other words, long term financing projects should contribute to serving the interests of the institutional investors' ultimate clients  and will have to compete with other investment opportunities available for institutional investors. Also the long term investments should fit in with the prudential rules and regulatory requirements which aim to safeguard the security, quality, liquidity, and profitability of the overall investment portfolio.

Prior to responding to specific questions posed in the consultation document, we will make a few general remarks.

**I. General remarks**

Beyond the immediate challenges of the European debt crisis and the Eurozone's future, the most important goal is to revitalise economic growth. For institutional investors sustainable economic growth is prerequisite to discharge their fiduciary duties and achieve sustainable investment returns. The Commission rightly identifies long term investments, efficient banking intermediation and a supportive regulatory environment as key elements in this regard.

Regrettably, the financial crisis has considerably weakened the abilities of banks - of which EU corporates historically largely rely on - to finance long term investment needs. Moreover public resources for long term financing have dramatically slumped over the past years. This 'long term funding cap' could by narrowed by alternative long-term financing resources, provided that existing obstacles in the financing environment are removed. We briefly comment on three of these resources below.

*1. Institutional investors*

As the Green Paper sets out, several initiatives across the EU have been launched to promote institutional investors to move into illiquid asset classes (e.g. mortgages, infrastructure and renewable energy) that support sustainable growth. These projects could produce predictable, inflation adjusted and stable cash flows over the long term, matching long institutional investor

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[2] http://www.eumedion.nl/nl/public/kennisbank/publicaties/2012_research_report_duration_and_turnover_dutch_equities.pdf.

existing liabilities and reducing their portfolio volatility. Also, the need for diversification and the search for yield in light of the low interest incomes might make it attractive to allocate a part of the portfolio to long term financing.

At the same time, it is clear that the long term duties and liabilities of an institutional investors are not synonymous with keeping illiquid assets in an individual project for the long term. Above all an institutional investor's responsibility is to apply an investment strategy that optimally serves the interests of its clients, whatever the nature and the duration of the investments. Moreover, prudential requirements and supervisory authorities' policies often discourage allocations to illiquid, long term instruments. For instance, Solvency II may discourage investments in infrastructure and in other less liquid long-term assets, according to the OECD.[3] Also, long term investment projects demand extraordinary efforts of institutional investors in terms of risk management and attaining specific knowledge.

*2. Developing EU bond markets*

An alternative option to strengthen financing through non banking parties and stimulate sustainable growth is to further develop EU bond markets. There is great potential for debt securities funding as currently only 15% of the credit needs of EU corporations were delivered via capital markets in comparison with 47% in the US. There is some evidence that already indicates a shift away from bank lending, but at the moment bond markets are accessible mainly for large corporates domiciled in countries with more developed corporate bond markets. A change in corporate and regulatory culture is needed to strengthen the debt capital market so that more medium sized companies have realistic options to replace bank loans by issuing bonds. This process of disintermediation may also free up a significant amount of capital that then can be allocated by banks to the smaller companies in need of credit.

*3. Reviving EU public equity*

In addition to bond markets, strengthening the position of the EU equity markets could be an important resource for long term investments and determinant of economic growth in the near future. Developing deeper and more liquid stock markets should therefore be a key priority. On the long-term, a more diverse financial system would be less vulnerable in the face of shocks.

However, the ability of equity markets to provide funding to corporates has been limited in Europe over de past years. European equity markets are relatively small compared with the US and

[3] See Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies, http://www.oecd.org/daf/fin/private-pensions/48616812.pdf.

Canada.[4] Currently, corporates are predominantly financed by bank loans, internal funds and – to a lesser extent – bonds. The preference for debt over equity is affected by a favourable tax treatment and the fact that the cost of debt finance has fallen significantly.

EU equity markets could improve its functioning to the long term benefit of both companies and investors and the wider society. Trading may have been being too concentrated on facilitating larger companies. Also EU stock exchanges' business models should increasingly focus more on attracting new IPOs, given the fact that the number of listed companies in the EU has dropped by as much as 27% in the past five years. In light of this the costs of an IPO need to be reduced considerably as these, including the fees required by investment bankers and lawyers involved, have appeared to be excessive in a number of cases of smaller companies seeking access to the regulated market.

In relation to the – from an institutional investor's point of view – most important questions we would comment as follows:

**II. Institutional investors**

*(6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

Eumedion believes that the question is not how institutional investors could invest more in long term projects (supply driven), but how long financing investment opportunities could be created that are really attractive for institutional investors.

To finance the long term liabilities that they have, institutional investors are looking to earn returns based on either growth of the entire economy (equity) or by earning a premium for credit and liquidity risk (bonds and direct finance). In principle, this objective allows institutional investors to contribute to stimulating to long-term investment by allocating funds to projects that support or enhance the productive capacity of the European economy. This allocation can be done to the extent that the defined long-term investment allocation is in line with the investment horizon objective (real or nominal) and within the risk constrains that they can tolerate.

In order to generally promote and sustain longer term investments by institutional investors some conditions ought to be fulfilled:

1. For the investment to be interesting enough for institutional investors, there needs to be a large enough choice of similar investments (universe) with each a large enough investment

[4] Llewellyn Consulting (2012): Financing European growth: the challenges for markets, policy makers and investors.

opportunity (funds required by the investment). This could be realised, for instance, through putting in place incentives to create investment funds specialised in long term projects, for example through a more favourable tax regime and more flexible investment rules, possibly through closed-end funds, given the lower liquidity of the underlying assets. Exemption of certain investment rules imposed on some institutional investors in the case of long term investments (e.g. minimum ratings, liquidity of securities, etc.) might also help.

2. A long term investment should contribute to reaching the institutional investor objectives and will have to compete with other investment opportunities available to the institutional investor. The project could for example have higher return to risk ratios, give better matching to the liabilities with for example via inflation linked cash flows or provide diversification benefits during certain risk environments.
3. Since the projects mentioned in the Green Paper are mostly illiquid in nature, the return on the investments needs to be high enough to include an illiquidity premium for the investment to be competitive with other investment projects. Therefore, creating specific benefits to institutional investors investing in long term projects, lower taxes on capital gains on long term financial instruments and guaranteeing risks, should be taken into consideration. These benefits would of course need to be balanced with any risk of misallocation of capital.
4. If the financing is done via one-project-one-financier, the financing could turn out ineligible because of concentration risk. Financing is much more attractive if a number of projects is pooled and the risk of the pooled projects can subsequently be shared between a number of financiers. Therefore it important to promote the creating of funds specialised in long term financing as mentioned under point 1.
5. Long term investment projects should give the investor appropriate insight in the intrinsic risks of the projects, including those of environmental, social and governance nature. Transparency and a good understanding of the risks involved in the project is one of the most deciding characteristics of an investment opportunity nowadays.
6. Institutional investors should subsequently be empowered to effectively monitor and, if necessary, influence management of the long term projects to which investments are entrusted.

*(7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

In order to support long term financing, regulatory asset risk capital charges should not weigh overly on the holding of long-term assets. Eumedion stresses that mark-to-market based prudential supervisory rules may sometimes impede long term investment. Specifically, this situation arises in the case of long term assets that have a regular cash flow pattern and which are in the portfolio to be held to maturity. Market prices (or mark-to-model prices) of these assets may fluctuate substantially, which may trigger a sale if the price of the certain asset drops too much, to protect the funding ratio of the pension fund. This bias for short-term risk management goals in solvency and funding regulations applicable need to be addressed to achieve a long term investment environment.

At the same time it is important to note that different asset classes, in a relative sense, are treated equally when it comes to prudential risk weighing. If illiquid asset classes would receive preferential over and above other asset classes, it could eventually lead to suboptimal prudential returns on investment.

Another issue concerns engaged share-ownership.  From the point of view of responsible investment, many institutional investors pursue a policy of engaged share-ownership. This means that institutional investors do not only invest in equity in the context of a buy and sell strategy, but also constructively engage with the companies they invest in. Concentrating the equity portfolio would make it easier and more cost beneficial to apply engaged share-ownership practices. However, the current risk models in prudential rules sometimes discourage concentrating and reward diversifying the equity portfolio.

*(8) What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?*

Pooled investment vehicles are in principle a very useful venue to channel funds into long term financing. There are several important issues for creating or investing through pooled investment vehicles. These issues are:

- Does investing through pooled vehicles bring enough benefits to justify the additional costs of investing indirectly?
- What will the tax treatment of the pool and its participants be in the various countries?
- How are the redemption provisions drafted?
- The ‘one solution fits all’ approach.
- How is the governance of the vehicles arranged?

With regard to redemption provisions, even though the intention is to invest for a longer term, unexpected circumstances can occur that force an investor to redeem its investment (partially or in whole). Especially in an illiquid fund, it is then important to know whether or not an interim redemption, if necessary, is restricted and if so, what the restrictions are.

The ‘one solution fits all’ approach of pooled investment vehicles, means that institutional investors are limiting themselves in their investment options. Every institutional investor has his own point of view and desires with regard to preferred size, type and credit risk of long term financing. These different preferences cannot all be catered to through a pooled investment vehicle, since the investment vehicle will have to work based on standardised units.

Further, the governance of these pooled investment vehicles is important for long-term investors. Who is ultimately responsible for the investment decisions the fund makes, and how much influence do individual investors have? This can be especially problematic in investment vehicles where a large number of investors participates, thus reducing the influence on investment decisions each of them has.

*The EU level*

If a pooled investment vehicle is structured at the EU level, attention should be paid to the tax treatment of such a fund. Under Dutch tax law the tax provisions are designed in such a way that the tax burden is the same for the situation of a direct investment by the investor, an investment via a tax transparent fund or an investment via an opaque fund. If the tax burden is much higher when using a pooled investment vehicle, the use of such fund will not be appropriate for investors.

The most important condition for pooled investment vehicles to become a success is that investors do not only pool money, but also knowledge. By pooling existing knowledge, institutional investors may profit from each other’s expertise in different areas so that all of them stand to gain from a pooled investment vehicle. This does probably limit the scope of the pooled investments to local level rather than EU level, since pooling knowledge is much easier to bring about in a cooperation where the parties involved already know each other.

*(9) What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?*

As mentioned above, Eumedion believes that transferring corporate lending from banks to debt capital markets (disintermediation) will not only boost the development of EU bond markets and thus create new investment for institutional and other investors. Also, it could relieve the pressure on European banks and enable them to meet other long term finance demands which could not be fulfilled via capital markets. Therefore, EU banks should actively support and facilitating private placement of debt to investors in Europe and by more actively syndicating the issuance of bonds to investors in euros, rather than the banks taking on the credit risk themselves.

We also see merit in a greater role for the European Investment Bank (EIB), owned by and representing the interests of the EU Member States. In this respect we support the joint Project Bond initiative, jointly set up by the European Commission and the EIB. The initiative seeks to demonstrate the feasibility of bond financing for infrastructure projects. This could mitigate the risks underlying the long term infrastructure investments.

### III. The combined effects of regulatory reform on financial institutions

*(10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?*

Eumedion notes that the regulatory framework could make long term financing more attractive. Neither solvency and prudential regulation nor financial market regulation should be counterproductive to long term financing. There should not be any provisions discouraging long term financing in a direct way (prudential rules), but also will it be very important to review the indirect influence of the various pieces of regulation. Such legislation can refrain institutional investors from making long term investments due to funds/money needed as a consequence of such legislation. Examples are the proposed introduction of Financial Transaction Tax, margin requirements for OTC derivatives (cleared and non cleared), strict liquidity requirements under UCITS and AIFMD, trading requirements for large in scale and illiquid orders as proposed in MiFID II /MiFIR, tax inefficiencies between EU Member States and others. Consequently, the total costs of regulatory reform/change of the market structure will be substantial for the end investors, affecting institutional investors' asset allocation policies and restricting the pool of (illiquid) assets they can invest in.

However, we do support introducing specific regulations on high frequency trading (HFT) as long term institutional investors face difficulties from some of those HFT strategies in their daily trading activities. HFT strategies require attention from regulators and should at least be made subject to minimum resting periods and cancellation rates.

## IV. Accounting principles

*(20) To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?*

With respect to fair value, Eumedion considers that investors with a long term horizon are in need of corporate reporting that enables them to judge the risks and rewards of investments accurately at any moment in time, even if they intend to hold on to securities for many years. This is because long term investors typically need to make reinvestment decisions on received dividends, interest, and returned principal on maturity. They also need to manage in- and outflows in their funds, apart from implementing their evolving vision on the financial and non-financial characteristics of their investments, and the portfolio as a whole.

For specific line items in the financial report, fair value is by far the best basis for measurement. If for these line items the fair value is not provided, users of financial statements will need to make their own time consuming and much more inaccurate estimate of fair value based on the non-fair value data provided. The unintended consequence of these judgments is that this causes significant uncertainty for investors, for which they will require an additional risk premium. This higher risk premium may and will cause a number of investors to decide not to invest at all, even though the underlying risk and reward characteristics of the investment would justify an investment. This is not short termism by investors; this is valid long term investor behaviour since the created uncertainty by less relevant reporting is uncertainty that needs to be rewarded as it is the investors' fiduciary duty to do so.

In some cases fair value measurement of an asset is criticised because a related liability to this specific asset is not measured at fair value. From an institutional investor perspective, there indeed is discontent with this situation; but it is not because of the fair value measurement of the asset, it is because the liability should also be measured at fair value. In other words, from an investor perspective not only these assets, but also the corresponding liabilities should be measured at fair value.

Limiting fair value accounting, is more likely to induce management to take excessive risks as in an optimistic scenario, profits can be easily recognised at the discretion of management, and in a negative scenario losses can be hidden under the carpet for a future generation to deal with. Indeed, fair value reporting is very important for proper accountability and holding management responsible.

## V. Corporate governance arrangements

*(21) What kind of incentives could help promote better long-term shareholder engagement?*

In order to encourage long-term share-ownership, loyalty dividend and loyalty voting rights are often mentioned as potential instruments. The underlying idea is that granting of extra dividend or extra voting rights may be a bonus for long-term share-ownership.

Eumedion has strong reservations about these two instruments, which include:

- Having a long term investment philosophy does not mean necessarily that the institutional investor will always keep the shares of a certain enterprise for the long term. If, for example, the price development of a share is such that the share is no longer undervalued, it is possible that a fund manager will sell the share in question, in the interest of safeguarding adequate results in the long term.
- Encouraging long term ownership does not necessarily lead to more involved ownership. It is uncertain whether the two loyalty instruments will reduce the so called “free rider” problem, as inactive shareholders also pocket the extra dividend or voting rights once a certain period has elapsed.
- Investment decisions may no longer be taken exclusively on the basis of the strategy and value of the company in question and the efficiency of the capital market will be disrupted as a consequence.
- The two loyalty instruments could set aside the so called proportionality principle, which means that the voting and dividend equity interest in a listed company should be proportional to the capital contribution of the shares.

Hence, we believe that the real issue is not how to encourage investors to keep hold of their shares for longer, but how to encourage more of them to take their responsibilities as owners more actively, irrespective of the length of their holdings.

Fit for purpose shareholder engagement could support boards in better management of the company’s affairs and may lead to greater investor confidence in the strategy of a company and in its implementation. Engaged share-ownership is an effective instrument for institutional investors to serve the interests of their clients as ultimate beneficiaries. However, shareholders' ability to monitor investee companies and ensuring that the governance is appropriate, depends on (i) effective disclosures, (ii) the attitude and responsiveness of boards of the listed companies involved and (iii) meaningful rights that can be enforced in practice.

In this respect, we are deeply concerned about the lack of progress on the exercise of voting rights through cross-border holding chains. While IT services and infrastructure for cross border voting have significantly improved over the years, there is still no uniform EU framework that governs issues that are of crucial importance for exercising voting rights cross-border. Ten years after the European Commission set out a roadmap for action to enhance the safety and efficiency of post-trading arrangements, we are still in the process of weighing regulatory options. We believe it is time for the European Commission, EU Member States and regulators to 'bite the bullet' and finalise the legislation needed shortly.

Unlike the OECD[5], we have witnessed a tendency towards significantly more engagement, encouraged by Stewardship Codes, principles, best practices and guidelines, developed by the United Nations (Principles for Responsible Investing), in the United Kingdom, the Netherlands, South Africa, Switzerland, India and by the European Fund and Asset Management Association (EFAMA).

Indeed, Dutch experience shows that adopting transparency requirements for institutional investors in a (soft law) code can contribute to shareholder engagement and investor awareness. Ever since the introduction of these requirements in 2004, we have seen a rather spectacular increase in the participation rate at the shareholders' meetings of the largest Dutch listed companies: from approx. 33% in 2003 to 65% in 2013. Partly as a result of these requirements, Eumedion was established, resulting in more collective engagement by institutional investors with Dutch listed companies. This has also been acknowledged by the Dutch Corporate Governance Code Monitoring Committee. In its 2012 monitoring report, the Committee concludes that in the Netherlands both shareholders and companies are investing in constructive, mutual relationships.[6]

We fully support the Commission's initiative, presented in the 2012 Action Plan on Corporate Governance and Company Law, to make listed companies remuneration policies subject to a vote at EU level. We further welcome the Commission's proposal to improve shareholders' control over related party transactions, which was also announced in the 2012 Action Plan. Related party transactions are of enormously importance to a company and its shareholders and it is of equal importance that the interests of minority shareholders are adequately protected, in particular when ownership of the listed company is concentrated. The 2011 Statement of the European Corporate Governance Forum on Related Party Transactions for Listed Entities[7] presents the Commission a

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[5] Croce, Stewart and Yermo, 'Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies', OECD Journal 2011, nr. 1.
[6] http://www.corpgov.nl/document/?id=663.
[7] http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf_related_party_transactions_en.pdf.

proper template for that piece of legislation. The nature of related party relationships and transactions may give rise to higher risks of actual or perceived conflicts of interest.

*(22) How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?*

Eumedion concurs with the Commission that the relationship, expectations and duties between 'institutional investors' (asset owners) and their asset managers could play a critical role in the dynamic of long term investment considerations.

As a general matter we are convinced that asset managers are capable of, and obliged – based on the Markets in Financial Instruments Directive (MiFID) – to adjust to different investors' needs, including long-term or short-term performance, but there seem to be potential issues regarding some pension funds' mandates. In practice the average duration of the mandate that a pension fund offers to an asset manager is three years and the pension fund's decision on whether to extend the mandate or not is often mainly based on the (relative) performance of the relevant asset manager in this period, mostly judged by market performance established by a benchmark. This performance period gives fund managers an incentive to pursue shorter term objectives than those of the ultimate beneficiaries.

These factors could contribute to an increasing incentive for fund managers to judge investee companies on their short-term performance, as Eumedion already mentioned in its March 2010 position paper on engaged ownership[8]. In addition, there is  tendency not to allow the performance of the institutional investor to diverge too much from the benchmark (index-tracking investment), so that investment decisions of asset managers are taken on the basis of the structure of a certain benchmark, instead of the quality of the strategy or value of the underlying enterprise.

Incentives for those involved in investment decisions are first and foremost the responsibility the sector itself. Participants in the investment chain have to achieve an alignment of long term interests through the whole chain. As the chain is often complex and differs from institutional investor to institutional investor, we would caution against imposing rigid rules. If measures are needed to limit short term incentives, a flexible best practice approach, driven by the sector itself is the most effective way to follow.

Given the nature of the principal-agent relationship, it is the institutional client (asset owner) task to communicate the investment objective of the investment mandate clearly to the asset manager. In

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[8] http://www.eumedion.nl/page/downloads/Position_Paper_Engaged_shareholdership_DEF.pdf.

principle, it is the responsibility of the institutional client to ensure that the mandate of the asset managers, including strategy, costs and engagement activities are aligned with the investment objectives for each mandate. The institutional client has primarily the power to set the rules for the mandates and he is expected to do that in the interests of the ultimate beneficiaries. In practice asset owners are increasingly aware of the need for clarity in their fund manager mandates on their expectations for long-term investment and engagement. To help address this the ICGN has published a model mandate in 2012 is to provide asset owners with model contract terms which aims to ensure that their fund managers act fully in their long-term interests.[9]

**VI. Information and reporting**

*(24) To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?*

Corporate reporting is of the utmost importance for investors. The current financial crisis shows that it in the interest of investors to look beyond the financial facts and figures. In the annual report, for example, the sections on risk,  corporate governance and remuneration have been attracting more attention from investors over the past years. And with the looming scarcity of natural resources and high qualified employees, and increased attention paid to the value chain, the information in sustainability reports have become even more relevant for investors. Both financial and non-financial information are therefore important in the decision-making process of investors and their portfolio managers. We believe that so-called integrated reporting is a logical and necessary development, as environmental, social and governance information is becoming more and more important in assessing the strategy and performance of companies, next to and as input for their financial performance. Integrated reporting may therefore provide a more holistic view of the company and a better understanding of company fundamentals and may therefore contribute to an environment of trust between listed companies and investors with a long term horizon.

[9] https://www.icgn.org/images/ICGN/Best%20Practice%20Guidance%20PDFS/icgn_model_mandate_mar2012_short.pdf.

We hope that our response is of any assistance. If you would like to discuss our views in further detail or need additional clarification, please do not hesitate to contact us. Our contact person is Wouter Kuijpers (wouter.kuijpers@eumedion.nl; tel. + 31 70 2040 302).

Yours sincerely,

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